Early days yet

Industry experts share their early assessment of the CSDR settlement failure penalties regime and how it has affected the industry since its implementation in February

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With the CSDR fails penalties regime going live back in February, how would you describe the market's level of preparedness for this deadline?

Paul Baybutt: There were some teething issues among a number of market participants on implementing the penalties regime as the Settlement Discipline Regime (SDR) infrastructure continued to be tested. Due to extensive planning and simulated testing at HSBC, we were able to reduce the impact of these problems and produce the required daily penalties reports for our middle office clients.

Rickie Smith: The SDR is arguably the most complex and extensive phase of the Central Securities fails Regulation (CSDR). In the lead up to the go-live there was a lot of uncertainty around the level of readiness from all market participants — from the central securities depositories (CSDs) and the chain of intermediaries, to the underlying investors.

The market had certain operational and technological challenges to overcome. Firstly, with regards to ex-ante measures to improve the pre-trade and settlement process, and secondly, in terms of building tools to ingest new SWIFT messaging types, reconciliation of penalty messages to underlying trade data, and defining new operating models for processing monthly cash penalties.

There was good engagement both in operations and on the business side in the two years prior to CSDR go-live. Across the industry there has been significant improvements in the operational models that support settlement efficiency.

Pre-go-live, market participants were able to engage in the CSDs trial process where offered, which focused on daily reporting and reconciliation without any cash processing. Although this enabled certain issues to be addressed and technology builds to be pivoted ahead of go-live, the market was unable to complete a successful month-end reconciliation process, leading to some uncertainties and challenges in the first few months of the regime.

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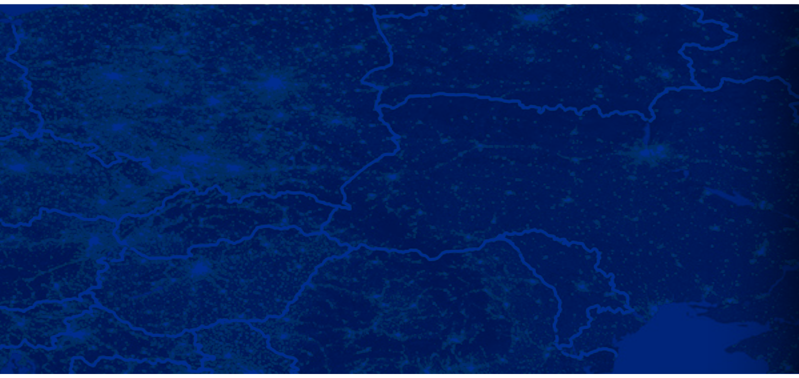
> **Daniel Carpenter, Meritsoft**

Daniel Carpenter: Most firms we spoke to over the course of 2021 had solutions in place to manage the penalties and appeals processes well in advance of the deadline. The year-long delay



undoubtedly helped those who were struggling with the original implementation date. A minority of firms held off committing fully to system and process updates pending a final decision on buy-ins — or perhaps they hoped that the entire rule set might be subject to further delay. Those firms left themselves with a lot to do in a very short timeframe.

Maciej Trybuchowski: The project we undertook to prepare the Central Securities Depository of Poland (KDPW) for the SDR was one of longevity. We worked to implement the changes resulting from the SDR by dividing the process into stages so that the new solutions could be phased in without becoming a burden for us and our participants.

Due to the postponement of the effective date of the regulation, in cooperation and after consultations with KDPW participants, we implemented the solutions step-by-step without waiting to implement the changes all at once on 1 February 2022. Most of the adjustments related to settlement support mechanisms at KDPW were already implemented in spring 2021.

The changes included the tolerance level functionality, changes to the cancellation of settlement instructions, modifications to the partial settlement functionality, as well as changes to the handling of the “place of clearing” field in settlement instructions.

1 February 2022 was primarily the effective date of charging cash penalties for late settlement. From the very outset, KDPW started to calculate penalties and distribute daily reports to KDPW participants.

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Pardeep Cassells
Head of financial products
AccessFintech

The level of preparedness for the go-live date of 1 February was varied across the market, with some CSDs unable to support requirements from the off.

This was indicative of some of the uncertainty around the regulation and how it would be supported, and potentially an underestimation of how technically complex the related data requirements were.

What are your early observations of the regulation and how has it affected the industry since its enactment? How has it changed market behaviour?

"Uptake of vendor solutions appears to be on the rise where, historically, counterparties were either unaware or consciously not fully utilising market level connectivity"

Rickie Smith, J.P. Morgan

Trybuchowski: Before the implementation of changes related to settlement discipline, KDPW had a system of penalties for late settlement in place. It covered a slightly different range of operations but it was much more restrictive, with higher fees. The implementation of the settlement discipline regulations was, without a doubt, a very expensive project. It required the development of a completely new system for calculating and reporting cash penalties.

From the perspective of the European market, it is important that standardised settlement support mechanisms are put in place in depository systems, including the tolerance level and the instruction matching requirement, as well as partial settlement. In the longer term, this should help improve the efficiency of settlement.

The implementation of settlement discipline arrangements, as of 1 February 2022, has not materially impacted the behaviour of market participants — settlement discipline has not improved markedly. Nevertheless, it is important to note that the implementation (in February 2022) coincided with market turbulence caused by the war in Ukraine.

Carpenter: The industry-wide imperative to reduce settlement failures led firms to prioritise budgets for this historically under-funded area of their businesses. Moving away from the manual or semi-automated processes of old, operations teams are now focused on greater precision around settlement instructions, fast access to a broad range of data sets from disparate systems, integration of client communications to facilitate rapid issue resolution, and end-to-end automation of the settlement workflow, right through to calculating and managing the penalty payments and receipts. Several of the firms we are working with have taken a more strategic approach, going beyond the regulatory requirements to analyse where trades are failing and why, across assets and across jurisdictions, so that they can make informed decisions about which of their counterparty relationships are profitable and which are costing them too much.

While it is too early to assess the broader impact of the new regime, the industry effort to improve fail rates comes at a critical time. Initial figures of around eight to 10 per cent settlement failures are being reported generally, and while penalties are not perhaps as high as was first anticipated, volumes and reconciliation activities remain high. Banks' margins are already under strain and the cost of funding is set to increase with the recent hike in interest rates, widely predicted to be the first of many throughout this year.

Cassells: A lot of the focus thus far has been on validating and data quality. A key component has been checking penalty information because of concerns around the rate of miscalculations and perceived errors on the part of the CSDs.

Certainly, it does seem that organisations are increasingly aware of their cost of fails and they are seeking to close out this risk quickly – this has been evident through the onboarding of solutions such as AccessFintech's (AFT's) Synergy to help reduce fails up front, and is being further reinforced through work towards the potential T+1 initiative in the US market.

I would expect a true change in market behaviour to take longer than just the two months since go-live. At this stage there are still some groups, such as asset managers, who have seen minimal direct impact and other business lines that are still finding their feet.

Smith: My initial observations, from a securities lending perspective, highlight an improvement in settlement rates from both new loans and loan returns. This indicates that there has been a definite shift in focus towards intraday settlement activity and process improvements with regards to the management of collateral.

Uptake of vendor solutions appears to be on the rise where, historically, counterparties were either unaware or consciously not fully utilising market level connectivity. Critical mass to adopt such solutions will lead to further efficiency improvements and will form an integral part of each firm's operational toolkit.

"We noticed that as the industry approached the implementation of the penalties regime, we had already seen an improvement in settlement efficiency, in terms of both improved settlement rates and shortened timeframes for settlement failures"

Paul Baybutt

Director, senior product manager, global middle office product, markets and securities services

HSBC

We noticed that as the industry approached the implementation of the penalties regime, we had already seen an improvement in settlement efficiency, in terms of both improved settlement rates and shortened timeframes for settlement failures.

This was down to the steps firms had already taken to address the reasons for settlement failures which saw them implement changes prior to the penalties regime being enacted.

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How well are market participants managing the processing and reconciliation of daily fails reporting and the monthly fails summaries from the CSD? How well are they equipped to allocate these cash penalties (or credits)? And to draw insights from this data that can improve their processing efficiency?

Smith: Within J.P. Morgan Trading Services, our purpose-built reconciliation engine is validating the daily reported penalties against a trade instruction, prior to communicating anything further down the chain to our clients, achieving a high percentage of straight-through processing.

The most challenging part of the settlement penalties process is the reconciliation between the daily reported amounts against the monthly net amounts, prior to processing the cash settlement.

Given the industry did not see a successful test of the month-end processing through the trial window, this does present a concern which could result in various manual interventions to resolve reconciliation issues, and significant delays to the allocation and attribution of net amounts to the underlying investors.

Intermediaries, within the settlement chain, have had to invest heavily in automating the reconciliation and penalty attribution process to ensure the penalty debits and credits are passed through to the underlying party in an accurate and timely manner.

Cash penalties data is only one aspect, coupled together with the trade settlement information along with the reasoning for the fails. This provides the basis to build a powerful story around understanding key metrics and trends impacting trade settlement.

From this data it will be clear where certain process improvements are required; then the business can prioritise addressing these areas to reduce settlement pain points and further increase operational efficiencies.

Cassells: Market participants are doing the best they can in terms of managing their daily versus monthly penalties, but they have faced a number of obstacles resulting from lack of detailed insight into intended processes prior to go-live.

These obstacles include CSD data quality and changing deadlines, among other factors, which all add to the complexity of this process.

Organisations without a streamlined and automated solution may find it challenging to allocate cash penalties and credits without significant manual effort, and it will be even longer before they begin to use the data to create efficiencies and drive down fails and mismatches.

Baybutt: The European Central Securities Depositories Association and the European Securities and Markets Authority (ESMA) have published an amended timetable for the collection of penalties, with the intention of providing participants with more time to receive details of a penalty and to reconcile it, while the CSDs have agreed to make adjustments in the next cycle to reflect that timetable.

At HSBC, even before the implementation of the penalties regime, we had detailed management information that has allowed us to draw insights from settlement reports. By using this historical data, we were able to model the impact that penalties would have. Although we already had high settlement efficiency rates, the data enables us to work with clients to address certain issues that might arise in the future.

Carpenter: We are seeing several issues, most notably with the formatting and sharing of SWIFT penalty messages. Not all international CSDs and custodians have followed Securities Market Practice Group recommendations detailing a standard format; therefore, data is being sent in multiple, bespoke formats. Some custodians are sending penalty messages using spreadsheets, thus reducing the expected automation benefits associated with ISO15022/SWIFT messaging. Additionally, inaccurate settlement data, for example around dates, is finding its way through to clients who must make the necessary amendments and then communicate the updates they have made.

While our CSDR solution caters for all these unique formats, firms still need to determine the data attribute mapping requirements from their CSDs and custodians for the automation and reconciliation processing that we support to be applied. Our solution provides access to said data and centralises it, making it easy for firms to perform in-depth analysis of settlement efficiency across all their counterparties. By adopting a more holistic approach that aggregates all the relevant settlement data from across the organisation and making this accessible centrally, firms can analyse this data to gain insight into which trades are failing to settle, with which counterparties, and why.

With this single view, new technologies such as artificial intelligence can increasingly be used to predict the likelihood of future fails and improve efficiency, while re-evaluating counterparty relationships to limit the incidence of failures — ultimately reducing their exposure to penalties. An added benefit is a reduction in the firm's exposure to costly interest claims.

"KDPW received only a few notifications of discrepancies in daily reports in February 2022. This was a great success — thanks to our staff that were involved in the project as well as thanks to close cooperation with market participants"

Maciej Trybuchowski
CEO
KDPW

KDPW received only a few notifications of discrepancies in daily reports in February 2022. This was a great success — thanks to our staff that were involved in the project as well as thanks to close cooperation with market participants — from which we were able to efficiently implement this complex project.

We do not have detailed information as to the level of alignment of individual KDPW participants, but given that thousands of penalties are charged at KDPW each day (as penalties are charged for each instruction not settled when due), it is reasonable to assume that participants are not processing the data manually.

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Do you anticipate that mandatory buy-ins will come into force, given that the MBI element of the SDR was postponed last February?

Trybuchowski: Mandatory buy-ins are highly controversial in the market. Comments in this area have mainly been raised by market participants who are the most interested in the issue at stake. Market participants should be listened to, and no solutions should be imposed against the will of the market.

Carpenter: Many firms we have spoken to are hopeful that the penalty regime, coupled with an industry-wide drive to address the historical issues, will minimise the likelihood of buy-ins.

They are focused on handling the current volume of fails, the associated penalties and client communications, as well as automating these processes to achieve the required levels of process improvement.

However, the door has been left open, and mandatory buy-ins (MBIs) remain in prospect if fail rates are not reduced to what the regulator deems an acceptable level. Time will tell how far the industry's collective efforts go in achieving this goal, but with no guidelines published on what constitutes "acceptable", we will have to wait for further information from the regulator.

Baybutt: Although mandatory buy-ins were postponed in February, ESMA has now published details of the CSDR REFIT. The REFIT will address two significant issues regarding mandatory buy-ins: the asymmetry of compensation, and the buy-in pass-on mechanism. ESMA has also noted it is possible that penalties alone will lead to an acceptable improvement in settlement efficiency. It is now down to the industry to continue to demonstrate this as the REFIT outlines that mandatory buy-ins will be implemented only if settlement efficiency does not improve to an acceptable level.

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> **Pardeep Cassells, AccessFintech**

Cassells: Given the recent European Commission update, it seems the market has been granted a reprieve in relation to the introduction of MBIs, with credit going to market bodies such as Association for Financial Markets in Europe, among other associations, who lobbied for this decoupling and delay.

The market now has an opportunity to show that settlement rates can be significantly improved and that the penalty regime is enough of a deterrent for bad behaviour to drive real change. It does feel that real work is needed to improve enough to keep the MBI regime at bay.

How effective has the CSDR settlement discipline regime been in meeting policymakers' goals of improving securities settlement in the EU?

Carpenter: We are encouraged by the efforts we have seen across the industry to bring about real improvements; it is no longer simply a compliance matter.

With the costs of doing business continuing to increase, there is a real drive to eliminate unnecessary expenditure.

The industry has known for many years that improvements in post-trade are needed, but CSDR has turned this "nice to have" into a "must have".

Just how well the process improvements put in place hold up in times of extreme volumes and market volatility remains to be seen, but reducing settlement fails must be a priority for all market participants.

March 2022 invoices will have delivered a reality check as the first wave of penalties hit. While daily data on failed settlements mean there will be few surprises, there will doubtless be a redoubling of efforts to reduce the bottom-line impact.

Cassells: Using the 8 per cent fail rate communicated in the recent ESMA Trends, Risks and Vulnerabilities Report of 2022, I would be interested to see the improvement rates in six months' time as an indicator of effectiveness.

Smith: It is a little early to say how successful the CSDR settlement discipline regime has been. Given the cash processing for the first set of monthly penalties has not yet materialised, many businesses may not have anticipated the financial impact.

This could be the catalyst for firms to increase focus on internal practices, with settlement efficiency being a higher priority.

Trybuchowski: It is difficult to assess the effectiveness of such revolutionary changes after only two months of operation, especially given the backdrop of a completely new situation: the war in Ukraine — which is also affecting the capital markets, particularly in KDPW's part of Europe.

The system of cash penalties is a very expensive solution to build and maintain.

The amount of penalties, at least in the Polish market, seems to be too low to improve settlement discipline, especially if you compare the amount of penalties under the CSDR to the penalties charged at KDPW before 1 February 2022.

Comments have been raised about settlement discipline in the process of the CSDR review, which suggests that the market recognises certain inadequacies of the regulations.

Baybutt: Early indications are positive, however, we will be better-placed to see the full picture in a few months' time, after initial implementation of the penalties regime and what its impact has been.

Q Building on this foundation, what are the next steps forward in eliminating settlement risk?

> *"As we noticed with the move to T+2, once one major market shortened their settlement cycles, the majority followed. The challenge for the industry will be whether other sectors of the investment markets can support the shortened settlement cycles"*
>
> **Paul Baybutt, HSBC**

Baybutt: For some, this is a move to the T+1 settlement cycle. It is not yet clear whether this is achievable or has universal support. Though, as we noticed with the move to T+2, once one major market shortened their settlement cycles, the majority followed.

The challenge for the industry will be whether other sectors of the investment markets can support the shortened settlement cycles. T+2 resulted in the settlement period for collective schemes in the UK to be shortened from T+4 to T+3; a move to T+1 for securities will likely cause the manufacturers of collective schemes to further shorten the settlement cycle to T+2.

The decision to move to T+1 should not be taken lightly, as today's T+2 cycle does allow there to be time to rectify any pre-settlement issues — time which would arguably be lost in a move to T+1 and, therefore, time that would need to recovered by better settlement monitoring tools.

Trybuchowski: Settlement risk cannot be eliminated in full but it can be minimised. The CSDR foresees the need to monitor and report cases of late settlement; however, it will take some time for the new system to settle before we can evaluate how effective it is. If necessary, existing solutions should be modified and improved, or new solutions should be sought. I am certain that not only CSDs, but also market participants, want to improve settlement discipline.

Cassells: Those organisations who were not quite ready to embrace CSDR in an efficient and automated way should now work to do so — removing team members who would be working on true settlement risk to instead reconcile penalty data seems counter-intuitive.

Pre-matching needs to become more consistent, more widely supported, and this should be achieved through data transparency. The real challenge that we have seen at AFT is the data quality across the market, which requires focused improvement. Better data quality, and collaboration based on that data, is how organisations can eliminate settlement risk seamlessly.

Rickie Smith

Executive director,
collateral services product manager
J.P. Morgan

In the short-term, a wider market adoption of partial settlement functionality will be key in reducing and minimising both the settlement risk and associated cash penalties resulting from a failing trade — though this will require all parties throughout the settlement chain to adopt the functionality.

Longer-term, within the securities financing and collateral ecosystem, several key initiatives within the digital space is a natural progression towards increasing market efficiencies through the elimination of settlement risk.

Although in its infancy, initiatives such as J.P. Morgan's Onyx intraday repo programme are starting to gather momentum, thus demonstrating how blockchain can be used to transfer funds and beneficial ownership of securities.

The evolution of such tokenised structures, which do not rely on physical market settlement at all (with both the loan and collateral settling digitally on the blockchain), will be a key step to eliminating settlement risk altogether.

Daniel Carpenter

Head of regulation
Meritsoft, a Cognizant company

Due to the global nature of capital markets, firms have continually struggled to manage failures across different systems and regions, and across distinct asset classes and clearing houses.

While the current CSDR penalties do not apply for trades failing to settle in non-European Economic Area jurisdictions, incidents such as the GameStop incident at the start of 2021 served to highlight the negative and destabilising impact of settlement failures across the global markets. This will become increasingly important as the markets look to reduce settlement times still further to T+0.

Based on our engagement with the market, we have seen an increasing number of forward-thinking firms sharing our vision for a more strategic approach to fails management that goes beyond CSDR compliance. This includes the expansion of our CSDR solution capabilities to cater for other settlement related costs, such as interest claims, and the expansion of solutions into a "single pane of glass" across all settlement systems, providing operations teams with a single portal to manage all exception and fail management activities.


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